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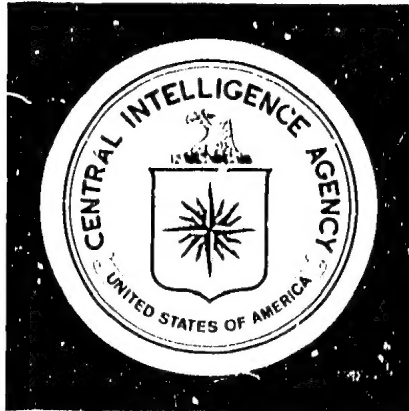
Egypt: Economic Outlook

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# Intelligence Memorandum

*Egypt: Economic Outlook*

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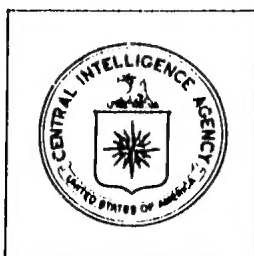
July 1975

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## Egypt: Economic Outlook

### KEY JUDGMENTS

Saudi Arabia has bailed Cairo out of a financial bind that threatened to force a cut in Egypt's imports, which were already at a politically marginal level.

With enough foreign aid to get through the next year or so, Egypt can expect a substantial increase in export earnings in 1977-78. Imports could then be increased considerably or dependence on foreign aid reduced.

In the long term, Egypt must increase its investment rate substantially to achieve rapid economic growth. Most resources for this purpose will have to come from abroad - mainly Saudi Arabia and private investors. The extent of this foreign support, as well as its efficient utilization, will depend on an easing of controls over private activity.

The prospect of breaking out of nearly a decade of economic stagnation gives the Egyptian government an incentive to avoid a new war with Israel.

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Note: Comments and queries regarding this memorandum are welcomed. They may be directed to [REDACTED] of the Office of Economic Research, Code 143, Extension 6981.

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## DISCUSSION

### Background

1. When Sadat became President of Egypt in 1970, he inherited a bankrupt and dispirited nation. Almost two decades of Arab Socialism had bureaucratized almost all economic institutions outside the rural sector. The 1967 war and Nasir's ill-considered "war of attrition" had deprived Egypt of assets that produced 7% of GNP. Recovery was hampered by inability to borrow at reasonable interest rates in the West -- a consequence of Nasir's overspending and repeated payment defaults. Even in Communist countries which accepted low-quality goods in repayment of economic debts, Egypt was in financial difficulties. Debt service on outstanding economic development credits exceeded the amount drawn under new development credits. Default on military debt was avoided only by successive repayment moratoria obtained from the USSR. Egypt had become dependent on the unreliable largesse of other Arabs, especially Libya, to finance a current account deficit that chronically exceeded US \$500 million a year despite severe austerity measures.

2. The burden of Egypt's economic difficulties fell most heavily on the urban Egyptian consumer. Lack of foreign exchange sharply limited the supply of materials, parts, and equipment available to Egypt's import-dependent manufacturing industries. Output in various consumer goods industries fell 10% to 60% between 1966 and 1972, seriously reducing the supply of domestically produced consumer goods available to Egypt's burgeoning urban population. The supply of consumer goods was further decreased by harsh import regulations that virtually excluded many categories of imported goods from the Egyptian retail market. By 1972, per capita availability of most consumer durables had fallen dramatically compared to 1964, the peak consumption year under Nasir's welfare state.

3. The continuing confrontation with Israel during the interwar years enabled the government to maintain a degree of financial and political control that otherwise would have been impossible. "War" taxes and periodic *Jihad* (Holy War) bond drives sopped up the excess demand created by guaranteed employment, annual wage increases, and rigidly controlled consumer goods prices in the pervasive public sector. Concurrently, the government was able to persuade urban consumers that the "war" was the cause of their many privations and that "peace" would restore the conditions that prevailed in the mid-1960s.

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### *Desocialization Proposed*

4. Unlike Nasir, Sadat was not deluded by his own propaganda. Sadat endeavored almost immediately to restructure the economy by supporting desocialization of key institutions sufficiently to attract foreign capital and foreign expertise. But his interwar plans for liberalizing the Egyptian economy were doomed from the outset. Constant threats of war and the prospect of union with Libya alienated most prospective investors, especially in conservative Arab countries, where memories of uncompensated nationalizations by Egypt during the divisive Yemeni war were renewed by Qadhafi's Nasirist posturings.

5. Egypt's economic situation worsened precipitously during the last year of the interwar period. Qadhafi, unable to control Egyptian expenditures of Libyan cash aid, cut off all *ad hoc* transfers, decreasing Egypt's FY 1973 foreign exchange receipts by \$150-\$200 million. Concurrently, Egypt's import bill began to mount because of rising wheat prices and falling crude oil output. By mid-1973 an economic nadir had been reached. Cash reserves had been drawn down to \$186 million, or 6 weeks' imports, and at least \$300 million in additional financing was needed to maintain existing levels of consumption and investment through yearend.

### *Financial Turnaround*

6. Egypt's financial position improved enormously after the October 1973 war. In response to the conflict, some \$800 million in Arab aid was transferred to Egypt during the fourth quarter of 1973. Following Israeli withdrawal, large sums from international sources were pledged to the highly symbolic restoration of the Suez Canal and its surroundings. Prices for Egypt's extra-long-staple cotton soared, resulting in record receipts of more than \$800 million for the 1973/74 crop. Payment of overdue foreign debts and a \$250 million increase in reserve holdings greatly enhanced Egypt's credit rating, assuring access to commercial and quasi-commercial lenders, unavailable for almost a decade. Extra cash and credit permitted Egypt to increase imports substantially during 1974, as shown in the tabulation. Stockpiles of essential commodities were replenished, equipment for reconstruction was obtained, and, compared with the prewar period, availability of consumer goods probably increased somewhat.

	Million US \$		
	1972	1973	1974
Current prices	1,425	1,593	3,028
1972 prices	1,425	1,448	2,226

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### **Immediate Postwar Problems**

7. Egypt's postwar euphoria was shortlived. For a time after the end of the war, an upsurge in tourism and in Arab investment in real estate triggered an urban economic boom such as Egypt had not seen for many years. It became apparent almost immediately, however, that the inadequate facilities and ill-planned institutions inherited from the Nasir regime would seriously hamper further economic growth. By late 1974, moreover, serious financial problems again threatened efforts to maintain economic momentum.

### ***Internal Problems***

8. The most debilitating legacy of the Nasir regime was a poorly designed, capital-starved economic infrastructure — a problem that had been obscured prior to the war by the magnitude of Egypt's foreign exchange shortage. The most formidable limitation on the level of economic activity in Egypt's import-dependent economy is the port of Alexandria, which had been functioning at near capacity since 1968-69 when harbors at Suez City, Ismailia, and Port Said were closed by the war of attrition. The postwar upsurge in imports hopelessly clogged the port. By the end of 1974, more than 100 ships were waiting to be unloaded, and Egypt had paid out \$100 million in demurrage penalties to owners of the stranded vessels. The situation was complicated by an equally inadequate internal distribution system that left piers buried under goods that would not fit into the port's limited warehouse space.

9. Moreover, the cumbersome state bureaucracy inherited from Nasir proved incapable of dealing effectively with these emergencies or with other problems arising from stepped-up economic activity. Overlapping administrative responsibilities, the rigidities of the state budget system, and a propensity for petty graft at all levels of administration slowed official reactions and impeded efforts to move ahead with new projects. Although Sadat has repeatedly discussed reorganization of the state sector, ministerial shakeups have resulted in little or no administrative improvement.

### ***Financial Constraints Reappear***

10. In the fourth quarter of 1974, Egypt's financial position began to deteriorate rapidly, mainly because of a sharp reversal in the terms of trade brought on by the combination of world recession and continued rapid inflation. Prices

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of imports continued the sharp upward trend that had begun in 1972, as shown in the tabulation. Concurrently, recession in Western Europe sharply curbed demand for Egyptian exports. At yearend, no orders for the 1974 cotton crop had been received from buyers in Western Europe, who in recent years had purchased up to 60% of the crop. This situation forced Egypt to slash prices and to seek alternative markets in soft currency areas. Luxury-oriented exports such as cut flowers and out-of-season vegetables also moved slowly in European markets, further threatening export earnings.

	1970 = 100
1972	106.1
1973	116.9
1974	145.1

11. Levels of Arab aid may also have fallen below Egyptian expectations during late 1974 and early 1975. In October 1974 the Arab Summit at Rabat allocated \$1 billion in grant assistance for Egypt. Largely because of Algerian and Libyan failure to pledge funds, final disbursement was only \$580 million. A supplementary Saudi allocation of \$100 million brought total cash aid up to only \$680 million for the period.

12. Failure to anticipate these shortfalls accurately (see Table 1) precipitated a serious liquidity crisis. According to preliminary balance-of-payments data (see Table 2), however, more than \$550 million in unpaid short-term debts were carried

Table 1

Egypt: Major Sources of Foreign Exchange Earnings  
1 October 1974 - 31 March 1975

		Million US \$
	Maximum Expectation	Maximum Actual Receipts
Total	1,890	1,380
Cotton	540	400
Arab cash aid	1,000	680
Other exports	350	300

over from 1974 to 1975. This carryover permitted a \$187 million increase in reserves which in turn was used as "security" for the additional short-term borrowing that forestalled a decline in imports in early 1975. Reliable banking sources report that at least \$1 billion and possibly as much as \$1.6 billion in short-term debt was due in June 1975. Although most bankers remain ready to roll over unpaid balances when due, penalties are rising rapidly and Egypt's improved postwar credit rating is eroding.



## Prospects for 1975

13. Thanks to the Saudi cash loan of \$600 million announced in June, Egypt will be able to avoid a financial crisis in 1975. Its trade balance probably will change little. Commodity prices may drop slightly and demand in Western Europe may revive later in the year, but such marginal improvements will be offset by sharply reduced oil output. Although the service sector offers greater hope, here too prospects are limited. At best, the Suez Canal will earn less than \$200 million, assuming former peak traffic levels are quickly regained. The postwar boom in tourism will be curbed by an acute shortage of hotel capacity that is being exacerbated by remodeling of several major facilities. Thus, if imports remain near recent levels, a current account deficit of \$1.7 billion can be expected (see Table 3).

14. On capital account, Egypt may have to repay up to \$500 million in long- and medium-term credits, raising the new funding requirements to \$2.2 billion. To cover these obligations, Egypt has access to: (1) the new Saudi cash loan of \$600 million; (2) \$900 million in cash aid already pledged by OPEC countries; (3) long-term trade and commodity credits totaling at least \$300 million; and (4) according to the IMF, \$350 million in project aid which can be drawn down. This prediction may be optimistic in view of the large sums allocated for investment in infrastructure and the small amounts of credit available for such purposes.

15. Egypt could face additional foreign exchange expenditures if debt negotiations with the USSR are not successful. The Soviets are seeking initiation of Egyptian payments on the principal sum of at least \$1.5 billion in military debts. In 1975, Egypt can count on exports of cotton and other goods unsalable in the depressed West to offset at least part of the increased outflow that military debt repayment would entail. However, if, as one report indicates, repayments approach \$300 million annually, a sizable net outflow is likely to occur.

Table 2

Egypt: Balance of Payments<sup>1</sup>  
1974

	Million US \$
Balance of trade	-1,356
Exports	1,673
Imports	-3,028
Net services	41
Current balance	-1,315
Grants	1,011
Net capital <sup>2</sup>	-225
Payments	-676
Receipts	451
Errors and omissions	55 <sup>3</sup>
Basic balance	-474
Financing	
Payment agreements	111
Banking facilities	550
Reserves <sup>4</sup>	-187

1. Because of rounding, components may not add to totals shown.

2. Long-term loans and supplier credits.

3. May represent transactions in the embryonic private sector.

4. A minus sign indicates an increase.

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16. In any event, Sadat's gamble in early 1975 that additional Arab cash would be forthcoming has paid off. Egypt probably will be able to get through 1975 without any cutback in imports. Moreover, banking sources indicates that repayment of some short-term credits had been delayed in the expectation that cash receipts would permit full repayment later.

#### 1977-78 - The Light at the End of the Tunnel?

17. Having acquired the resources to surmount the present liquidity crisis, Sadat can expect substantial relief over the next several years. Barring renewed hostilities, current foreign exchange earnings could rise rapidly - perhaps even double (an increase of some \$1.3 billion) - over the next 2-3 years. This would mean a large increase (more than 40%) in import capacity that would also be used to reduce dependence on foreign aid. If all of the increased export earnings were used to reduce foreign capital requirements, the latter would fall to around \$400 million on a net basis.

18. By 1978, transportation and distribution problems should no longer create an impediment to rising levels of expenditure. An expansion program being discussed with a variety of potential lenders will increase berthing space at the port of Alexandria by almost 50% by late in 1977. Meanwhile, the reopened ports along the Suez Canal will be able to handle increased tonnage. A major upgrading of the railroad system financed by the IBRD and procurement of additional road transport equipment with Iranian trade credits and Western aid should greatly relieve clearance problems at the expanded port. Although many problems in the distribution system will remain unsolved, these improvements will remove the principal obstacles to the free flow of goods into Egypt.

19. Cairo is relying most heavily on the petroleum sector to redress Egypt's unfavorable balance of payments. By late 1977 or early 1978 the newly discovered July and Ramadan oilfields in the Gulf of Suez should be producing 400,000 b/d. If declining output in the El Morgan field is reversed by a pressurization program

**Table 3**  
**Financing the Egyptian**  
**Balance of Payments**  
**1975 Gap**

	Million US \$
Trade balance	-2,028
Imports	3,028 <sup>1</sup>
Exports	1,000
Net services	350
Canal	175
Tourism	400
Worker remittances	250
Demurrage	-100
Other	-375
Current balance	-1,678
Debt repayment	-500 <sup>2</sup>
Required financing	-2,178
Available	2,350
Surplus	172

1. 1974 level.

2. Excluding military debt repayment.

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now under way in the area, total oil output may amount to 650,000 b/d. Even if excess output of an estimated 400,000 b/d is all sold as crude, Egypt's share of foreign exchange receipts would be about \$800 million at present oil prices.

20. Invisible earnings also are expected to mount. New hotels now being designed or constructed are expected to increase room space by at least 60%, mostly in the lucrative first class and deluxe categories. Egyptian officials expect tourist earnings to top the \$800 million mark by 1978, compared with a prospective \$500 million in 1975. If traffic follows presently predicted patterns, additional Suez Canal fees of some \$150-\$200 million also will be added to service earnings by 1978.

21. The Egyptians are fully aware that the sources of this prospective income are highly vulnerable. Another conflict in the area almost certainly would result in closure of or damage to the Suez Canal. Even the short October war resulted in shutting down the Suez oilfields for several months until mine fields and other hazards could be cleared. Even a serious threat of war quickly reduces the tourist trade. Familiarity with these and other economic consequences of war undoubtedly help to explain Egypt's flexible approach to negotiations with Israel.

#### Long-Term Prospects

22. Egypt has the potential to achieve rapid economic growth in the longer term - the Egyptians themselves mention a 7%-10% rate. The country has a large market; plenty of skilled labor; an adequate supply of managers, engineers, and other cadre; and a long tradition of effective, if not efficient, administration. The economy has been held below its potential by a severe shortage of foreign exchange, the priority demands of the conflict with Israel on the allocation of resources and on the attention of the leadership, and a system of bureaucratic controls that severely inhibits private activity. The requirements for rapid growth are thus: (1) obtaining dependable foreign exchange earnings; (2) raising substantially the rate of investment; and (3) providing a much more favorable environment for private business activity. Progress in all three directions will be much easier if there is no war with Israel. These conditions for growth are to some extent mutually dependent.

23. The economic troubles of the past several years have depressed investment even more than consumption. But there is already widespread dissatisfaction with living conditions, and consumption cannot be cut further without serious

repercussions. Under these circumstances, investment can be raised mainly in two ways: (a) a decline in current government expenditures, and (b) an increase in net foreign investment.

24. Major cuts in current government expenditures will have to come from the military, the bureaucracy, or subsidies to enterprises. Even if there is no war, the likely persistence of tensions in the Middle East make any major reduction in military expenditures highly unlikely. Nor does it seem politically likely that Sadat can rapidly reduce either subsidies to enterprises or the size of the civil service. This means that an increase in investment will have to be financed mainly from abroad – primarily with Saudi aid and private capital. Both of these sources of capital, however, depend on progress in liberalizing the private sector.

25. This analysis suggests that the main constraint on Egyptian growth will soon change from a shortage of foreign exchange to a shortage of capital – in other words, a resource constraint. We see no way rapid economic growth can be achieved without widespread liberalization. But such a step would be extremely difficult politically, and the Egyptian government is likely to move slowly and cautiously. The result will probably be an economic performance considerably better than the 4% real GNP increase achieved annually since 1970, but still well below what the country can achieve.